

HEARING ON TERRORISM THREATS AND THE INSURANCE MARKET
STATEMENT BY TERRY FLEMING ON BEHALF OF
THE RISK AND INSURANCE MANAGEMENT SOCIETY
BEFORE A JOINT HEARING OF THE COMMITTEE ON FINANCIAL SERVICES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
AND THE COMMITTEE ON HOMELAND SECURITY,
SUBCOMMITTEE ON INTELLIGENCE, INFORMATION SHARING,
AND TERRORISM RISK ASSESSMENT

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Good morning, Chairwoman Kelly, Chairman Simmons and members of the Subcommittees. My name is Terry Fleming. I am the Director, External Affairs, for the Risk and Insurance Management Society (RIMS), which is the country's largest professional risk management organization. I am also Director of Risk Management, Montgomery County, Maryland. I appreciate the opportunity to appear before you today on behalf of RIMS to talk about terrorism concerns and the insurance market, particularly from a risk manager's perspective.

RIMS represents the commercial consumers of insurance. As the country's largest professional risk management organization, RIMS represents nearly 4,000 industrial, service, nonprofit, charitable, and government entities, including 83 percent of the Fortune 500 companies. Our members, corporations, public entities, and municipalities, buy insurance and have a strong view on the need for, and availability of, insurance to cover risk against terrorist acts. Risk management is the practice of analyzing an entity's exposures to loss, selecting methods to mitigate the exposures, implementing the selected methods, and monitoring and adjusting the methods depending on the results. Applications for risk management cover all possible exposures to loss, ranging from estimating the number of employees who will be injured in a given period

to how to effectively use arbitrage in a global business. The methods used to mitigate exposures are non-insurance transfers, insurance, control, retention, and avoidance. For terrorism exposure, most businesses use a combination of control, retention, and insurance as mitigation strategies. For example, Entity A owns real property worth \$10 billion. Much of the property is located in the central business districts of several large cities that are considered targets of terrorism. In an attempt to control exposure to loss, the company has implemented a security program consisting of cameras, motion detectors, and alarms as well as an employee identification badge program to restrict access to its buildings. Visitors are limited to one entrance where security staff logs them in and out. Redundancy and security are built into all vital computer operations.

Entity A also purchases an all-risk commercial insurance policy to cover the property including coverage for terrorism. Using a large deductible, the company retains some of the exposure. In the event that the Terrorism Risk Insurance Act (TRIA) is allowed to sunset on December 31, 2007, the entity will most likely be unable to obtain the limits of coverage they would like and therefore would have to retain a much higher level of financial risk for losses caused by terrorism.

One of the basic functions of risk management is to identify potential risks for a company in areas such as property, health and safety, and environmental and financial risk, and to identify options to mitigate those risks. Insurance coverage is a critical and necessary part of the process of protecting our companies from risk, especially risk that can produce catastrophic losses. Terrorism is one of those risks that presents catastrophic exposure to companies. Accordingly, it is vital that terrorism insurance continues to be

available to buyers of commercial insurance in a comprehensive and affordable manner when the Terrorism Risk Insurance Act (TRIA) expires.

RIMS considers the availability of adequate insurance for acts of terrorism to be not simply an insurance problem, but a national security and an economic issue. The inability to acquire sufficient insurance for terrorism coverage could result in the inability to secure financing for future construction projects, could affect existing construction projects that require evidence of terrorism coverage, and could result in major uninsured losses in the event of an act of terrorism. The last four years have demonstrated that the private insurance market alone will not be able to respond nor provide adequate coverage for acts of terrorism. Acts of terrorism are too difficult to predict and therefore exceedingly difficult to price. To be insurable, expected losses must be reasonably estimable, and terrorism losses simply do not fit this criterion. For this reason, the private market has not provided adequate coverage without the federal government acting as a reinsurer of last resort. With the federal government acting as a reinsurer, there is at least some level of certainty for private carriers in predicting their maximum exposure.

Recent hurricane activity is an indicator of the effects of the industry's inability to appropriately predict and quantify large risk. There are a lot of data (100 plus years) about storms and weather patterns that are used in scientific models to predict storm frequency and severity. Unfortunately, the past four years have been totally out of the loss predictability range. The consequences are significant disruptions in the catastrophe insurance market with reduction of limits, downgrading of insurers financial ratings, insurers and reinsurers reducing their policy writings, and in some cases carriers exiting the market completely. It is significant to note that most of the uninsured portion of these

losses is ultimately picked up by state and/or federal governments without the benefit of insurance premium. Unpredictability of losses is many times greater for terrorism risk than for storms, as there are no credible historical data on losses. It is impossible to predict frequency with any degree of accuracy, and it is extremely difficult to estimate the frequency and severity of a potential terrorist event, as the timing, location and target cannot be identified in advance. Therefore, it is unreasonable to expect that the insurance market is going to respond to the need for terrorism insurance when it is having great difficulty responding to the need for more predictable risk like natural disasters.

Having adequate insurance coverage for U.S. businesses is important to the economic well-being of the nation. Without some form of backstop like TRIA, RIMS believes insurance companies will review their portfolios of business and will refuse to continue covering certain risks in areas where exposure is greatest. This would be true for workers compensation, property, and even third-party liability lines of coverage. Both large and small businesses would be affected. Such reductions in the supply of coverage could result in a significant national economic crisis. Many businesses in the United States rely on global insurance companies for coverage. These insurers decide where to underwrite risk based on their assessment of overall profitability in return to their shareholders. If the risk to write coverage is perceived to be too great, U.S. businesses will be left without the coverage they need.

After September 11, 2001 and prior to the passage of TRIA, RIMS members who have large concentrations of employees had difficulty in purchasing workers compensation insurance. Many RIMS members also found it difficult to purchase property insurance, including coverage for terrorism on buildings and construction

projects. TRIA has provided market support to ordinary employers, not just to owners of potential target buildings or businesses in a few major cities.

RIMS recently conducted an informal survey¹ of its members, asking questions about terrorism insurance coverage to get an idea of current market conditions. Eighty-six percent said that if TRIA or some other federal backstop were not in place, they do not believe that they would be able to obtain sufficient coverage for acts of terrorism at affordable prices. Eighty-two percent believe that coverage should be available for nuclear, biological, chemical, or radiological (NBCR) attacks. However, 91 percent said they did not have coverage for NBCR. Eighty-six percent said they do not think NBCR coverage would be offered by the private sector at all without a TRIA-type backstop in place.

As an indicator of what might be expected if a TRIA-type program were not in effect, 75 percent said that prior to the recent extension of TRIA, their policies contained terrorism coverage conditioned upon the extension of TRIA. Seventy-six percent stated that they believe their terrorism coverage limits would have been decreased had TRIA not been extended, and 82 percent felt their premiums would have increased if TRIA had not been extended. In this regard, one of our members reported that the premiums for coverage of a property in a large metropolitan area went from \$200,000 in 2005 to \$500,000 in 2006, for one half of the policy limits they had in 2005. Furthermore, the member's broker has stated that carriers are unwilling to commit to insuring projects inclusive of TRIA if the completion dates go beyond December 31, 2007, the sunset date.

RIMS believes it is critical that a program be developed to insure continued coverage for acts of terrorism, including nuclear, biological, chemical, and radiological

¹ A copy is attached.

acts. The federal government has stated that potential acts of terrorism from these sources are likely. RIMS believes that NBCR represents some of the most problematic areas in the ongoing terrorism debate. The stand-alone terrorism insurance market continues to be extremely limited, in that it really only exists for the property line and is very limited in terms of capacity and price. Rating agencies are increasing the capital requirements for reinsurers, which means that they cannot write the same limit of coverage as last year without increasing their capital reserves. The practical impact is that available limits of coverage will be reduced. RIMS believes that it is critical that a long-term solution be developed to insure that terrorism insurance will be available.

RIMS believes that the following principles should apply to development of any long-term solution:

- A completely private market solution in the long term is probably not feasible because of the difficulty in predicting acts of terrorism and thus being able to price the risk properly. Businesses, as part of their corporate governance, need to be able to assess what the business risks are and how they can be quantified and treated. Without a TRIA-type program, many entities will simply be self-insured due to lack of availability or affordability of coverage or both—leaving their companies and their workers exposed to an event that could bankrupt the company.
- As risk managers, we believe that a program should already be in place to ensure an orderly and efficient response to minimize any market disruptions and ensure benefits are available to any victims—individuals or companies from a catastrophic loss scenario.

- A private/public partnership provides the best alternative to addressing the long-term needs of availability and affordability of insurance to cover acts of terrorism. Some form of risk pooling may be an appropriate approach. Regardless of the extent of private market involvement, the federal government will likely be required to continue to be involved in a reinsurance capacity at some level with the level of involvement decreasing over time.
- The solution needs to address the long-term availability and affordability of insurance coverage for nuclear, biological, chemical, and radiological (NBCR) events caused by terrorism.
- The distinction between “foreign” and “domestic” acts of terrorism should be eliminated.
- All commercial property, workers’ compensation, auto and general liability lines should be included in any new plan.
- Insurance companies writing commercial lines should be required to participate in the program and be required to make coverage available for acts of terrorism.
- Tax incentives and eligibility for participation in the program should be considered to encourage creation of private insurance capacity.

Thank you for the opportunity to testify on this extremely important issue. As we look to the future, it is imperative to find a way to provide effective and reasonable commercial insurance options against catastrophic terrorist attacks. RIMS appreciates your Committees holding this joint hearing and looks forward to working with you to address the issue of terrorism and insurance.